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CURRENCIES AND CREDIT MARKETS

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"In the end, it will again be the real capital structure, and not the money structure, which determines the relative competitive capacities of different nations."

Marx and Keynes, Paul Mattick, p. 183
Merlin Press, 1980.

HIGHLIGHTS

Watching the soaring financial markets around the world following the break-up of the EMS, convinces us all the more that we are witnessing a once-in-a-lifetime financial mania. While it may last for a while, it's an absolute certainty that it will end in a bang, not a whimper.

What has really happened in recent years is the Americanizing of world financial markets. Economic and business fundamentals have gone out the window; short-term interest rates and monetary policy alone determine stock and bond market values.

Frenzied speculative periods are always propelled by popular myths. Their deceptions usually only come to light when its already much too late. We identify three myths.

Surveying the world's major economies, we see no prospect for a sustained up-turn anywhere. However, it is worth reviewing the respective differences in economic and financial fundamentals.

It is now generally accepted that the economic recovery in the United States and other major countries is being inhibited by the unprecedented debt problems and structural maladjustments. Everywhere it has the same cause: a collapse in investment expenditures.

In the United States, unprecedentedly large monetary and fiscal stimulus has failed to stage a self-feeding economic recovery. The current economic weakness is not a pause. It's an end.

Besides the weak monetary and economic data, we identify three big drags on the U.S. economy that act to pull it down: fiscal policy, the trade deficit and investment.

Interest rates in the U.S. ought to be much higher presently. The paltry supply of new domestic savings relative to the huge U.S. federal budget deficit is one of the reasons.

The dollar is in jeopardy. A relapse of the U.S. economy and a soaring trade deficit makes its position extremely precarious.

Long-term capital conservation and liquidity continue to be the top priorities. We continue to recommend safe harbour in the short-term money securities and bonds of the strong-policy currency countries — Germany, the Netherlands, Switzerland as well as Austria.

A GLOBAL CHASM: BOOMING MARKETS, LAGGING ECONOMIES

Stock market fever is boiling up and has been levitating markets everywhere. It's become a world-wide mania. In fact, there isn't a stock market anywhere that could be considered reasonable value by historical standards. Oddly, it was the recent break-up of the European Monetary System (EMS) that ignited a new explosive euphoria under the financial markets. While European politicians may be mourning the EMS's demise, markets — particularly European stock and bond markets — are simply ecstatic, celebrating it as the impetus for easy money and buoyant financial markets the world over.

Liberated from the shackles of quasi-fixed exchange rates, the happy reasoning is that European countries are now able to push harder for economic growth. If Europe can be expected to slash its interest rates, acting to jump-start its economies, the thinking is that it will in time also help the U.S. economy. Even more joyously received is the notion that interest rates the around world will now be freed from the stubborn grip of the German Bundesbank. And lower interest rates — at least the way the Anglo-Saxon stock markets interpret them to the exclusion of almost everything else — means soaring stock prices.

On the matter of the rigid European Exchange Rate Mechanism (ERM), we share the view that the currency speculators did a good job of blowing it up. What the world needs presently is policy flexibility to allow suitable responses to differing domestic requirements, not policy paralysis. However, the allegation of the French and the British that Germany's Bundesbank is to blame for destroying the ERM is not valid. It should be remembered that the Bundesbank's constitutional task is to defend the German currency, not grander dreams of France's political elite.

. . . A CELEBRANT EUROPE

Recalling the recent doom and gloom about Europe's supposedly frightful economic prospects, this abrupt switch to a rampant financial euphoria has taken us somewhat by surprise. Barron's described it nicely: *"Foreign and domestic investors alike scrambled aboard a sinking ship to capture the best deck chairs from which to watch, and maybe profit from, a pending disaster."* What's really happened in recent years is a thorough Americanizing of world financial markets. Economic and business fundamentals have gone out the window; interest rates and monetary conditions alone determine security values.

What's happening in Europe, in essence, is a literal replay of what occurred in the U.S. in October 1990 when it was realized that the American economy was sliding into recession. Immediately recognized was that a hard economic landing — in contrast to the earlier expected soft landing — implied falling interest rates and, voila, the U.S. stock market immediately shot up in celebration even though business profits and economic conditions were to remain sick for years to come.

WARPING STOCK MARKET DYNAMICS

Actually, it's the norm for stock markets to begin rising at this juncture in the business cycle — the stage when business conditions are deteriorating and interest rates begin to drop sharply. As a rule, changes in monetary policy and money growth lead stock and bond prices which in turn lead the business cycle. All through the postwar period, this pattern unfolded perfectly every time. That's why stock prices are a sizable component of the official U.S. leading economic indicators. But it's only valid as long as business activity follows the lead of money growth and securities.

A big exception to this rule occurred once before — in 1929. Business activity peaked in June of that year, whereas stock prices peaked later in September and then crashed in late October. In fact, it was the

spectre of a booming stock market which deceived so many people about the economy's true vulnerability at the time. It's a fact of life that when people feel good about financial markets, they tend to feel assured about the economy.

This time, anomalies are truly rampant. In the past, a monetary easing, generally typified by sharp cuts in short-term interest rates, normally caused a regular sequence of identifiable effects. The first to respond were always the stock and bond markets in association with rising money and credit growth. In due time, usually no more than one year, the excess money which poured into financial markets began spilling over into the real economy . . . that is into the growth of employment and production which initiates the new, cyclical recovery.

THE SEEDBED OF FINANCIAL SPECULATION

What's gone wrong this time? For the economies that went into recession first — some years ago in 1989 and 1990 — the typical boom in the financial markets arrived without any delay. But in stark divergence from the norm, all the other regular effects of a monetary easing largely remain missing.

Protracted, unprecedented sluggishness in credit and broad money growth clearly signals that the monetary stimulus has failed to reach the real economies. It is as if financial markets and real economies have become completely disconnected. Contrary to any experience in the postwar period, a growing gap has opened between increasingly bullish and highly-valued financial markets and the dismal underlying performance of the real economies.

Adding greatly to the confusion in the major countries — Japan, the U.S., Britain, and others — is the unprecedented experience that narrow money supply (M1) has exploded on the upside alongside stagnating broad money supply (M2, M3, M4). In the United States, in particular, where bank reserves and the monetary base have skyrocketed as well, it gave rise to serious inflation fears even in the midst of near-recession in the real economy.

In contrast to the prevailing fears, we have taken a somewhat opposite position. We have always emphasized that, yes, there is an inflation in the United States — one that could even be called a rampant inflation. But the inflation we see is confined to the financial markets. Prodigious monetary stimulation, as reflected in soaring bank reserves and rock-bottom short-term interest rates, vents itself into frenzied speculation in stocks, bonds and derivative instruments. On the other hand, the protracted weakness in broad money and credit flows is directly inter-related with economic activity and clearly implies that the monetary channels into the real economies are clogged. More or less, the same picture is evident in most countries.

The country that is the furthest advanced with this syndrome is the United States. Since 1989, the U.S. spigots of monetary and fiscal stimulation have turned on as never before. While the Fed slashed its Fed funds rate from almost 10% to 3% and simultaneously swamped the banks with excess reserves, the administration doubled the budget deficit to about $300 billion annually. Together it has added up to a stimulus of unprecedented magnitude.

True, the U.S. economy did recover . . . barely. The most ominous and disturbing aspect is the colossal disparity between the record-sized doses of monetary and fiscal stimulation and their puny effects on the real economy.

Officially, the U.S. recovery started in March 1991. U.S. real GDP (Gross Domestic Product) has since grown a cumulative 4.2% or 2.2% annually which, by the way, is below the economy's annual growth potential of 2.5%. That compares extremely poorly with the average cumulative GDP growth of 10.2% during the first two years of previous postwar cyclical upswings.

On the other hand, while the Fed's liberality has grossly failed in the realm of the real economy, it has hyper-stimulated the financial world. The Wilshire Index of 5,000 stocks appreciated from a value of $2,772 billion on Oct. 10, 1990, to over $4,500 billion by the end of August 1993. That's a gain of well over 60% and compares with an average gain in business profits of about 20%.

RATIONALIZING THE SPECULATIVE BUBBLE

Frenzied speculation is always seasoned with myths. We see a number of them presently. The first is the belief that the sharp decline in U.S. interest rates is the healthy reflection of declining inflation and inflationary expectations which gives rise to the suggestion that investors are rushing into bonds.

None of this true. The Fed's quarterly Flow of Funds Accounts clearly bears evidence. But who bothers to check? Apparently, nobody wants to investigate for fear of spoiling the party. The truth is that it has been the Fed, the commercial banks and the brokers, egged on by the lavish policies of the Fed itself, that have been the dominant buyers of bonds and are pushing U.S. long-term interest rates downward.

For example, here is what really happened in the U.S. credit markets during the first quarter of 1993. On an annualized basis, total borrowing amounted to $529 billion, the government and its agencies accounting for $447 billion or 84% of the total. The Fed kept its funds rate at 3% and glutted the banks with reserves by purchasing $49.6 billion worth of government bonds. Given the lack of credit demand, the resulting excess reserves in turn put the commercial banks under pressure to buy bonds. Their purchases amounted to an annualized $100.2 billion during that quarter. Brokers and dealers snatched another $40.5 billion for their on-going game of playing the sharply positive yield curve with cheap short-term money. Broadly, the combined bond purchases of these three buyers — the Fed, banks and brokers — financed two-thirds of the Federal budget deficit. Money pumping by the Fed and nothing else is the true reason for the incessant fall in U.S. long-term interest rates.

Normally, over the long run, interest rate levels are determined by the balance between credit demands and the available supply of savings. Considering that the mammoth U.S. federal budget deficit exceeds the paltry supply of new savings, U.S. interest rates ought to be much higher. It goes without saying that the extremely low interest rates presently are even more poison for savings. When interest rates are so low there is little encouragement to save.

MONEY DECEPTION

Another myth is the widespread assertion that the booming stock markets in the United States, Japan and Europe are "liquidity-driven". By traditional definition, markets are liquidity-driven when the money supply grows faster than nominal GDP. That was the case worldwide after 1984 when the U.S. recovery faltered. The Fed started to ease aggressively and the foreign central banks monetized massive dollar purchases in order to slow its steep fall.

But that episode of exploding international money growth ended abruptly in 1990. Since then, the exact

opposite has happened. Instead of exceeding GDP growth, money growth has been increasingly falling short. Germany is the sole major exception. To speak of "liquidity-driven" markets is therefore a misnomer. Financial markets are booming in a world of shrinking overall liquidity as reflected in the protracted weakness and deflationary trends in the real economies. The graph below shows the money growth trend of the G6 countries.

G6 MONEY GROWTH TREND
U.S., JAPAN, GERMANY, FRANCE, U.K. AND CANADA
M2, Year-over-year Per Cent Change

Source: International Strategy and Investments

Looking closer, we must distinguish between two different liquidity trends in most countries. Aggregate liquidity is generally shrinking relative to nominal GDP. However, within the broad aggregates there continues to be a big shift towards narrow money (M1). What this shift reflects is frenetic financial speculation. Keynes would say that the financial sphere is stealing money away from the real economy.

Specifically, with respect to the U.S. financial markets, we identify two different channels of liquidity into the financial markets. In either case, the Fed plays the dominating role.

The first is the booming U.S. bond market. As described, it is largely the product of the Fed's plentiful reserve injections. By forcing the banks into heavy bond purchases, this reserve policy has lead to extensive money creation and sharply lower long-term interest rates.

On the other hand, the booming stock market is largely the product of the Fed's interest rate policy. Private investors, stunned by the sharp decline in short-term interest rates on banks' time and savings deposits, have been pouring their money into equity mutual funds, driving stock prices higher and higher. In contrast to the purchases of bonds by banks, however, the shifts out of bank deposits into mutual funds and securities by private and non-bank investors leaves the total broad money supply unchanged. Yet, the spurt in financial transactions essentially inflates the need for demand deposits and therefore buoys narrow money (M1).

This explosive rise in demand deposits, mainly reflecting rampant financial speculation, has an intriguing side-effect. Banks' demand deposits are subject to reserve requirements which must be held on account at the Fed, the central bank. Therefore, as these deposits soar, bank reserve requirements rise in step. Normally, this would put upward pressure on short-term interest rates. However, the Fed is preventing that from happening by supplying whatever reserves are necessary to meet the system's requirements. That explains the Fed's persistent, large bond purchases.

The point is that the Fed, through its reserve and interest rate policies, has succeeded magnificently in turning the whole U.S. financial system into a perfectly working perpetual motion machine for financial speculation. As long as that's the case, why worry unduly about the real economy?

QUESTIONING THE FED

Contradicting the rosy consensus view, we have always stressed the artificiality and vulnerability of both the current U.S. recovery and the associated boom in the financial markets. Investigating the causes of the prolonged, extraordinary weakness in broad money, we have insisted that it means precisely what it implies — that economic activity is sluggish at best. Unprecedented weakness in money growth happens to coincide with an economic recovery of like weakness.

Being unable to influence money and credit trends, Mr. Greenspan and the Fed have decided to overcome this failure by ignoring it. M2 has been effectively discarded as an official monetary target. Above all, the Fed alleges that it is the unprecedented steepness of the yield curve that is distorting M2 growth on the downside. To quote Mr. Greenspan: "*Low deposit rates have induced savers to cut back on holdings of deposit liabilities included in M2... The unprecedented steepness of the yield curve is pulling deposit funds into capital markets.*" In addition, it's believed that the yield curve has shifted borrowing and lending away from the banking system to the cheaper money and capital markets.

Logical as this explanation sounds, it's dead wrong. It's not the first time that we've questioned the knowledge of Fed experts about the monetary mechanism — how money is created and destroyed. What's wrong in the first place is Mr. Greenspan's belief that the large money flows into mutual funds automatically reduce the money supply. They don't. As we've explained in previous letters, money supply contracts only when businesses or consumers repay loans.

Mr. Greenspan's second big mistake arises from the fact that he completely ignores the flip side of the steep yield curve: namely, the massive bond purchases of the banking system. These purchases are just a different form of lending, mainly to the public sector. Rising bond holdings increase the money supply just as much as rising bank loans. Remember that bank holdings of bonds have increased by a staggering $213 billion over the last two years.

Over the 1991-92 period, banks, with their bond purchases have financed 21.3% of the total credit expansion. During 1983-84, their share was 24%. True, the banks have lost some market share, but not nearly enough to explain the extreme divergence in M2 growth between the two periods. In 1983-84, M2 growth was 21% and in 1991-92 it was 4.5%.

THE REAL CAUSE OF LOW MONEY AND CREDIT GROWTH

Forget about mutual funds and other technicalities. One must look at the broad picture which is determined by total credit. That explains why the U.S. recovery has been still-born right from the beginning. The decisive differences with past cyclical recoveries are of two kinds: first, a virtual collapse in total credit growth; second, a radical change in the credit pattern. More than anything else, it is the purposes for which credit is used that determines the effect on the real economy.

A comparison with the 1983-84 recovery highlights the impact of these differences. Total credit expanded altogether by 28% in 1983-84. In 1991-92, it only expanded 9.6%. That makes a difference.

The second big and crucial divergence is found in the pattern of borrowing and spending. In 1982-83, the public sector — the Federal, state and local governments — gobbled up 34% of total new credit. In 1991-92, their share was 65%. Private borrowing has thus been crowded out.

But who in the private sector has been crowded, the consumer or businesses? Almost exclusively, it has been businesses. For comparison, in 1982-83, businesses borrowed a total of $447 billion, while in 1991-92 they have instead repaid $15 billion. With these two figures you really know everything about the current U.S. economic recovery. The table below provides some greater detail.

Being dead wrong in the assessment of M2 and the causes of its ominous, protracted anaemia, Mr. Greenspan and the Fed are essentially just as wrong in their assessment of the U.S. recovery's strength and sustainability. As late as July 20th this year, Mr. Greenspan in his Congressional testimony predicted that real GDP growth for the second quarter of 1993 would be between 2.5 to 3%. One week later, the Commerce Department published an estimate of 1.6%. The latest calculations now only put it at a 0.6% annual rate, following the measly 0.7% growth in the first quarter.

U.S BORROWING TREND
COMPARISON: 1983-84 VERSUS 1991-92
Billions of Dollars

	1983-84	1991-92
Total Credit	$1,318	$1,035
Federal Government	382	582
State & Local Govt.	70	85
Consumers	418	330
Businesses	447	-15
Foreign	26	38

Though this economic weakness greatly surprised the consensus, it hardly challenged the prevailing optimism at all. Future growth forecasts remain as positive as ever. It simply remains a foregone conclusion that U.S. real growth will snap back to a 2.5 - 3% annual rate in the second half of 1993. But with two months of the third quarter already behind us, neither the economic nor the monetary data bear this assumption out.

RECENT MONEY GROWTH JUST A BLIP

There has been some modest strength in the monetary aggregates recently. Exclusively, it's coming from a new bubble in narrow money (M1) which is plainly related to the latest surge in the financial markets. During May-July, M1 surged by $42 billion or at a 16.3% annual rate. M2-minus-M1 declined at the same time by $11 billion and M3-minus-M1 by $24 billion. In other words, more of the same: all new money goes into financial speculation at the expense of the real economy.

All other economic data are not given the slightest support to the forecasts of an improving U.S. economy either. What, then, are all the optimistic forecasts based upon? More than anything, it appears to be blind and steadfast faith in the stimulative power of low inflation and record-low interest rates despite the many disappointments so far.

Our own view is very much the opposite: There is not a shred of evidence that the U.S. economy is resuming growth. It's clearly faltering again. Despite unprecedentedly massive monetary and fiscal stimulation, the resulting lacklustre recovery lacks any dynamics.

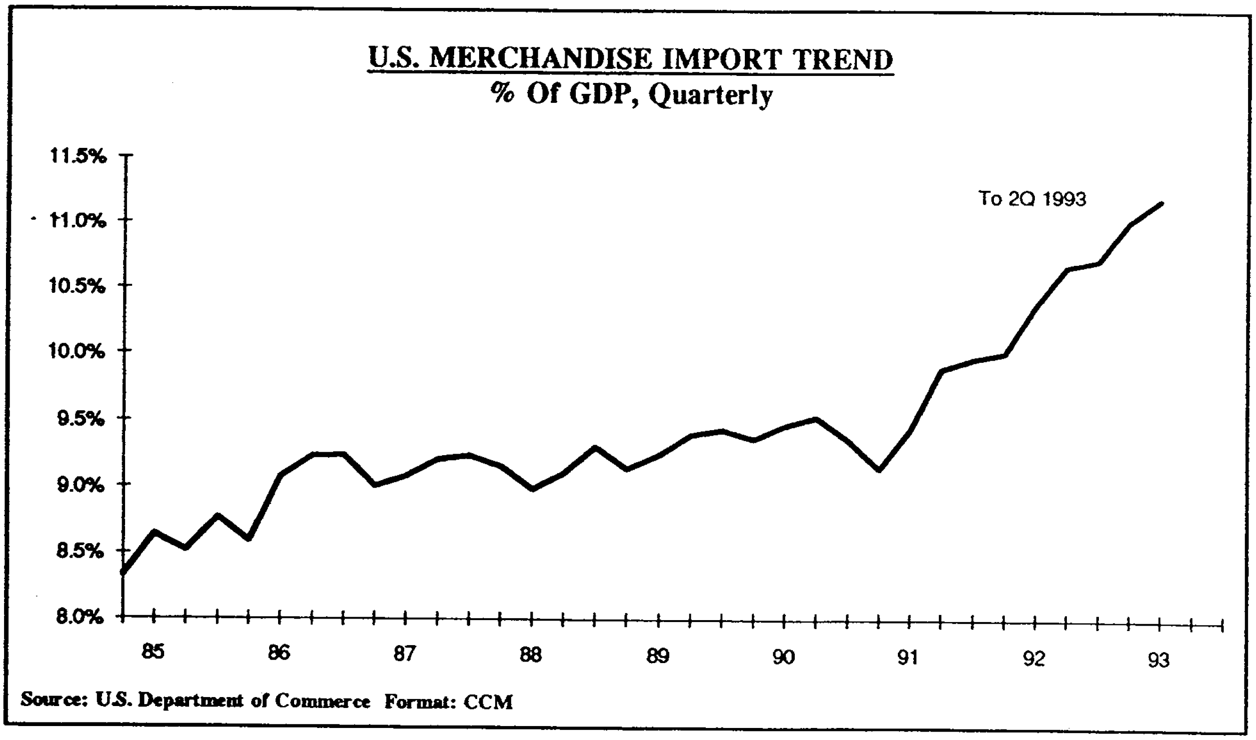
THE U.S. ECONOMY UNDER DRAG

However, by no means are the weak monetary and economic data the only elements pointing to a regressive U.S. economy. Our worrying view is mostly determined by the recognition that the U.S.

economy is being impacted by three major drags. The first one is the Federal budget with its considerable cutbacks in defence spending and the Clinton tax increases. After all, it was a big fiscal boost that had given the economy strong support in the period through 1989-92.

A second big drag is the rapid widening of the U.S. trade gap caused by the coincidence of slowing exports and soaring import penetration. For this recovery, between the first quarter of 1991 and the same quarter of 1993, the import volume of goods has skyrocketed by 26% compared with a rise of only 4.5% in the domestic spending of goods. Final sales of goods grew a mere 1.45% during the full two years.

In actual fact, the rapidly widening trade gap is playing a key role in undermining the U.S. economic recovery. It's robbed the economy of approximately half of its domestic demand growth during the first two quarters of this year. Since the end of 1989, when the U.S. economy first began to weaken, imports of goods and services have risen from 11.4% to 13.3% of GDP as the graph below highlights. GDP grew a total of only 3.1% in this period. Essentially, this dramatic deterioration of the U.S. trade balance raises critical questions about the dollar.



The third major drag on U.S. economic growth is sharply slowing fixed investment. In addition to the bulging budget deficit, it was a small boomlet in residential building and investment in plant and equipment that gave the recovery some momentum. Housing is virtually flat though hopes are riding high that the lower long-term interest rates will revive it.

INVESTMENT IS THE KEY TO RECOVERY

It is now generally accepted that the economic recovery in the United States and other major countries is being inhibited by the unprecedented debt problems and structural maladjustments that accumulated

during the prior boom. Essentially, these ailments vary in kind and degree between different countries. But one consequential effect is the same everywhere: a collapse in investment expenditures. It is in this sector that one must look for the explanation to the world's prolonged recession.

In Britain, during 1990-92, fixed investment fell by more than 30% or about 4% of GDP. Japan's recession is led by a similar downturn in industrial and commercial building investment. In Canada, investment fell by 12% or 2.5% of GNP over the same period.

Just recently, the Federal Reserve Bank of New York published a very detailed study analyzing the slow-growth period of 1989-92 from a historical perspective. It clearly shows that the relative weakness in investment spending is the most outstanding difference between the present and past U.S. recoveries. (Please see the adjacent table.) Real wage growth and consumption growth have been much lower than usual as well. But it is investment that always provides the great spark for these in recovery periods.

U.S.: HISTORICAL COMPARISON OF RECOVERY PERIODS
First Eight Quarters of Recovery, Cumulative Per Cent Change

	1991-I 1993-I	1982-IV 1984-IV	1975-I 1977-I	1970-IV 1972-IV
Real GDP	4.2	11.6	9.9	10.5
Consumption	4.4	9.7	10.7	11.6
Fixed Investment				
Durable Equipment	18.6	31.2	15.0	24.3
Non-residential Structures	-13.7	9.4	0.7	3.8
Residential Investment	23.7	51.5	47.3	42.6
Real Wages & Salary	1.9	9.1	6.0	10.0

Source: Federal Reserve Bank of New York, Quarterly Review, Summer 1993

A good look at these figures should destroy any existing illusions about the viability of the U.S. recovery. It clearly reveals its outstanding vulnerability. Past cyclical recoveries were all driven by a burst in investment spending which consequentially led to sharp increases in employment, consumer incomes and consumer spending. Yet, strangely, we hear laudable mention that investment has held up relatively well in this past recession. That may be partly true against the backdrop of the unusual weakness of the recovery. However, compared with past recoveries, this upturn has been far below par.

What this Fed study does as well is dispel the comforting notion that the recent U.S. recession wasn't so severe as earlier postwar recessions. Actually, with a real decline of 2.2%, it was a little above the average of 2%. But to fully grasp the structural disaster that has struck the U.S. economy, it is necessary to look at a more extended period. What really frames the situation is the unusual weakness of growth both before and after the recent recession. Quoting their comment on the rise in real GDP over the four-year period between early 1989 and early 1993, it represented *"the weakest performance since the Great Depression."*

The study illustrates this fact by comparing the four-year periods during which the six postwar recessions occurred. The figures on the next page illustrate the extreme differences in composition and strength of growth between the present period and those in the past.

In general, the study confirms our long-expressed view that the U.S. economy is in a deep structural crisis which is manifested in two protracted and savage drags on economic growth. One is the investment collapse and the other is soaring import penetration. In the investment sphere, the problem is that the chronic weakness in industrial investment is now greatly aggravated by weakness in building.

A WHOLE WORLD IN THE SAME SOUP

Being downbeat on the U.S. economy doesn't necessarily imply that we're optimistic about others. In most countries, downturns have slowed or given way to modest upturns. Still, a true self-feeding recovery is nowhere to be seen. For that to occur would require an investment boom either in building or producer's plant and equipment. Since both remain in the doldrums, and likely will continue to do so, we see a world-wide, self-reinforcing economic weakness.

What the soaring stock markets really reflect is excess optimism, not excess liquidity. This optimism has its root in two main convictions: first, that lower interest rates will, in time, dislodge the sluggish economies and lead to accelerating growth; second, that business profits are bound to rise due to cost-cutting and downsizing.

U.S.: HISTORICAL COMPARISONS OF PAST RECESSION PERIODS
Four-Year Period Per Cent Change

	1989-II to 1993-I	Average of Preceding Cycles
Real GDP	3.3	11.5
Consumption	4.8	14.0
Fixed Investment		
Durable Equipment	9.8	14.5
Non-residential Structures	-17.6	7.1
Residential Investment	-5.8	17.3
Industrial Production	2.8	12.6
Real Wages & Salary	1.1	10.5

Source: Federal Reserve Bank of New York, Quarterly Review, Summer 1993

Considering the accomplishment so far of the countries that have already slashed their interest rates long ago, this lingering faith in the power of easy money is astonishing. As for the prospect of higher business profits, the widespread belief in the overall salutary effects of cost-cutting is simply wrong. When companies can only raise their profits at the expense of the incomes and profits of others, it becomes a zero sum gain. One entity's income gain is the loss of another. Over the longer run, expanding profits depend on expanding economies, particularly expanding investments. That is the dynamic that has been clearly evident in the high-growth Asian countries such as China, South Korea, Singapore and others.

THE DOLLAR - THE FIRST VICTIM

The upshot of our analysis is that world business conditions remain fragile. There is much hand-wringing over the recession in Europe. Given that other countries — the U.S., Britain, Canada, Australia and a host of others — had already succumbed to recession much earlier, Europe's downturn hardly deserved the great sensationalization that it received by the media. The far greater calamity is the fact that the countries who went into recession first proved unable to stage a normal self-feeding recovery. We find it curious that these truly foreboding developments are completely neglected. Yet it has far-reaching implications for the currency markets, in particular the dollar.

Gauging the U.S. dollar, we distinguish between cyclical and structural influences that determine its performance. To begin with, it was the perception of a brisk U.S. cyclical recovery relative to the recession-bound European economies that propelled the U.S. currency upward.

Well, Europe has its recession, but the U.S. recovery is proving to be far weaker than the dollar bulls had expected. Therefore, the rise in U.S. short-term interest rates that the dollar bulls had anticipated has not occurred. In our view, that alone should put an end to the dollar rally.

But another great danger for the dollar now arises from the rapidly weakening trade gap. Sooner or later,

this development must lead to a fundamental reappraisal of the health of the U.S. economy and its currency. Not only does it seriously undermine the recovery, it flies smack in the face of the general perception of the U.S. economy's superior international competitiveness and grossly undervalued dollar.

These perceptions usually found their basis in the highly popular PPP theory (Purchasing Power Parity). We have never taken these calculations seriously and have repeatedly criticized them. To compete successfully in world markets requires more than just low wages and an undervalued currency. More than anything else what's required is growing production capacity, specifically in manufacturing.

What these PPP fans completely overlook is that there is a widening investment gap between the U.S. economy and the rest of the world. The U.S. capital stock is progressively declining relative to foreign capital stock, particularly in the industrial sector.

Wall Street loves corporate downsizing and rationalization, seeing it as a prescription for perpetual rises in business profits and share prices. It ignores the important fact that shrinking capacities and record-low new investments are a sure-fire way to lose market share in a world where many foreign competitors invest heavily. Essentially, the resulting capacity constraints limit U.S. export and import-competing capabilities regardless of competitiveness in prices and costs.

In the final analysis, all of the ills of the U.S. economy can be traced to a single structural deficiency: abysmally low savings and investment ratios. And unfortunately, rather than showing any improvement, these conditions continue to worsen.

For the time being, markets aren't overly concerned with the widening U.S. trade gap. Comforting explanations are always at hand. But seen against the backdrop of protracted economic sluggishness, this development is calamitous. At the same time, compounding the problem, record-low U.S. interest rates act to weaken the capital account. Given these serious negatives, the outlook for the dollar is becoming highly precarious.

CONCLUSIONS

For the reasons explained, in our view, the U.S. recovery has definitely peaked. The only question is how much economic weakness is to follow. The most important issue for the investor is how a renewed economic downturn will impact the currency and financial markets. In our opinion, a renewed downturn would be something entirely unexpected.

Slowly and grudgingly, the dollar bulls are starting to consider their error. But the decisive shock is still to come when the markets finally realize that the paltry U.S. recovery has been more or less aborted. Then, the market will suddenly come to focus on all the other ignored negatives — the soaring trade deficit, abysmally low savings and investment ratios.

With its recent decision to leave interest rates unchanged, the Bundesbank again has demonstrated its uncompromising stance on fighting inflation. This decision forces the other European central banks to review the agenda for their monetary policies. Overall, the case for lower interest rates is clear.

What has surprised us, given our view that European economies remain mired in recession, is the extreme bullishness in Europe's stock markets. You might say that Wall street has come to Europe. Primarily at

the behest of U.S. money managers — who are loath to miss any stock market upturn and are diversifying away from high-priced U.S. markets — we see the Anglo-Saxon financial mania now spreading abroad in earnest.

Bearing in mind the U.S. experience where a drastic monetary stimulation has failed to benefit the real economy, we urge caution. Low and falling interest rates may provide short-term support to the stock markets, however the associated assumptions about the future course of the economies and business profits are wildly over-optimistic. Simply put, share prices are ridiculously overvalued worldwide. Investment risk has gone from bad to terrifying.

A sharp fall in the dollar, which we expect, will provide an appropriate opportunity for a monetary easing in Germany and Europe. As such, selected European bonds should continue to perform well.

We stand by our long-running recommendations: For American investors, there is little else to do other than to continue seeking safe harbour in riskless short-term money and to diversify into hard currencies. Investors outside of North America should stick with bonds in the strong-currency countries, namely Germany, the Netherlands, Switzerland, and Austria.

Next Mailing: October 6th

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